Variable Remuneration
A Commentary on Market Practices

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Introduction

This GRG Remuneration Insight provides commentary on findings published in the 2020 GRG Variable Remuneration Guide (the Guide), which analysed the short and long term variable remuneration designs and practices of companies in the ASX200. Being the largest companies listed on the ASX it was expected that their practices would reflect good corporate governance and modern approaches to variable remuneration. Unfortunately, this is not universally the case, although underlying plan designs are often slow to change, we observe more rapid changes in how they are configured annually, for example, over the last 2 years there has been a rapid rise in the use of financial return metrics.

Single Incentive Plan Experiment Fails

Of the swathe of 'simple incentive plans' (SIPs) introduced by companies in the ASX200 in the last 5 years, only 12 remained by 30th December 2019, and more have since been replaced this AGM season. These are variable remuneration plans essentially based on huge short term variable remuneration (STVR) plans where awards are delivered in a combination of cash and equity which needs to be held for some time and may be subject to service or performance vesting conditions.

Regular readers of GRG's Insights would remember that we warned about the shortcomings of SIPs upon their introduction and they have also been the subject of strong criticism from proxy advisors particularly because they promote short-termism and do not have a longer term performance focus. They have also resulted in strikes being received on Remuneration Report resolutions at AGMs as they have been poorly regarded by shareholders.

One of the main nightmare scenarios we outlined for SIPs was what would happen if a lot of companies had "a bad year or two", resulting in complete destruction of the long term alignment opportunity due to short term issues. COVID-19 has brought that issue to the fore perhaps sooner than expected.

The recent announcement by Wesfarmers (seen by many as the champion of SIPs) that it is discontinuing its SIP has undoubtedly signalled the end of the experiment with a poorly thought through approach to variable remuneration. Their solution to the COVID problem is, unbelievably, to guarantee a minimum level of short term award outcome, completely destroying the short term alignment. One has to wonder if they have forgotten what the original objective was.

Mix of Variable Remuneration Elements

The following summarises the mix of STVR and long term variable remuneration (LTVR) among ASX200 companies.

Market Capitalisation Range	MD		Direct Report	
	STVR	LTVR	STVR	LTVR
>$10b	54%	46%	60%	40%
$5b to $10b	48%	52%	63%	37%
$2b to $5b	56%	44%	65%	35%
$1b to $2b	38%	62%	46%	54%
$0.5b to $1b	39%	61%	45%	55%

This table indicates that companies with market capitalisations of less than $2 billion are adopting sound principles in relation to the mix of STVR and LTVR. The well-established principles are that:

1. Managing Directors/CEOs should have a significantly heavier weighting on LTVR than on STVR because they need to focus on the long term prosperity of the company (1.5 LTVR : 1 STVR or 2 LTVR : 1 STVR), and
2. Direct Reports to the MD/CEO should have either an approximately equal balance (1:1) between STVR and LTVR or a slightly heavier weighting on LTVR (>1 LTVR : 1 STVR).

Companies with market capitalisations over $2 billion tend to be overweighted in STVR and underweighted in LTVR for MD/CEOs. This overweighting of STVR is more pronounced for Direct Reports where nearly two thirds of variable remuneration is via STVR and only one-third is via LTVR. This departure from well-established principles is difficult to justify particularly when it is recognised that executives in companies with market capitalisations over $2 billion receive greater variable remuneration opportunities than do executives in smaller companies in addition to their higher Fixed Pay levels. Anecdotally, it appears to have been driven by activist shareholders and proxy advisors pushing for high levels of STVR deferral in addition to LTVR, which executives and boards then tend to count as equivalent to LTVR, even though the vast majority of the realisable value is based on short term outcomes.

Deferred STVR

The majority of ASX200 companies defer part or all of STVR awards into equity which is subject to vesting and/or holding conditions. The original trigger for the commencement of deferral of STVR awards into equity was a desire to expose STVR awards to the longer term consequences of actions taken to qualify for the STVR award. This desire has been largely unfulfilled as there is little, if any, alignment between changes in the value of deferred equity and the impact on the company of inappropriate actions taken to generate STVR awards.

More recently, the focus has moved to a requirement for executives to have “skin-in-the-game” via conversion of STVR awards into equity which needs to be retained for significant future periods. Further, the deferral of STVR awards into equity has also been seen as a means of ensuring the equity is available for retrieval under company clawback and malus policies, should the need arise.

Smaller companies, not in the ASX200, tend to have not adopted the practice of deferral of STVR awards into equity. Generally, they have seen it as more appropriate to start with the right mix of STVR and LTVR and then combine it with disposal restrictions on LTVR earned equity and security holding guidelines for senior executives and directors. Perhaps this is an area where larger companies can learn from smaller companies.

LTVR Rights Continue to Dominate

Analysis of LTVR plans show that equity instruments continue to dominate as virtually no plans are based on cash payments. Of the equity instruments, Rights remain the instrument of choice with a small minority of companies choosing Options (or the more modern Share Appreciation Rights equivalents) either in preference to Rights or in combination with Rights.

The change that has occurred is in relation to the type of Rights used. Share Rights have been replaced by Indeterminate Rights. This change has been to address retirement benefit limits and taxing problems that can arise on termination of employment when Share Rights are used but can be simply overcome when Indeterminate Rights are used. Options are being replaced with Share Appreciation Rights because they are 50% to 70% less dilutive for the same benefit to the participant.

LTVR Outcome Metrics

It is interesting to note that most companies have moved to the use of two or more performance vesting conditions with one typically being a form of total shareholder return (TSR) and the other being a financial performance metric.

In relation to TSR performance metrics there has finally been a decline in the use of ranked TSR (rTSR) which involves comparing the percentile ranking of a company's TSRs with the TSRs achieved by companies in a comparator group (often criticised as being a "lottery"). Other forms of relative TSR are growing in usage such as indexed TSR (iTSR) where a company's TSR is compared to a vesting scale related to a TSR Index, removing the "lottery-like" outcomes.

For many years, the dominant financial performance metric used has been earnings per share growth (EPSG). Recent findings have shown a significant movement to the use of other financial return metrics nearly as often as EPSG.

Type of TSR Measure	No. of Companies	%
rTSR	103	71%
iTSR	17	12%
Absolute TSR	22	15%
Absolute Share Price Growth	3	2%
Grand Total	145	100%

Please note companies may have multiple types of this kind of measure

Type of Financial Measure	No. of Companies	%
EPSG	62	40%
Return Measures (eg ROE, ROIC)	57	37%
Other Financial Metrics	37	24%
Grand Total	156	100%

Please note companies may have multiple types of this kind of measure

Again, regular readers of GRG's Insights would remember that GRG always advocated not blindly following ranked TSR and EPSG unnecessarily.

Environmental, Social and Governance (ESG)

Emerging performance metrics are ones related to ESG issues. Because of the significance of such metrics for some companies or difficulties in their measurement, they tend to be used as 'Gates'. A Gate is when a failure to meet required standards (such as a major environmental incident, APRA intervention or reputational issues caused by management) would result is no LTVR vesting, irrespective of performance in relation to other performance metrics.

More Information

If you wish to discuss any aspect of concern in relation to your company's variable remuneration plans, then please feel free to contact one of GRG's experienced remuneration consultants on (02) 8923 5700. We do legal and tax in-house, at the same time as advising you regarding market leading practices and stakeholder weighting/management, giving you a wholistic, tailored answer.

If you would like to purchase a copy of the 2020 GRG Variable Remuneration Guide then please place an order via info@grg.consulting.